DR. KURT RICHEBÄCHER

Frankfurt
GERMANY

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"By 1929, speculation on Wall Street attained fantastic dimensions . . . It's difficult to understand how highly intelligent experts seriously believed that the boom could go on forever, how they failed to realise that the position was becoming increasingly dangerous with every rise in equities and with every increase in the volume of fictitious wealth."

World Finance Since 1914, Paul Einzig, p.158
Kegan Paul, Trench, Trubner, London, 1935

HIGHLIGHTS

In the last letter, we uncovered the causal linkages behind the extremely divergent behaviour of narrow and broad money on the one hand, and the financial markets and the real economy on the other.

In this issue, we give a detailed, historical perspective on how such conditions essentially give rise to the ominous and legendary "financial bubble".

What's wrong with an asset bubble that has the wonderful effects of raising asset valuations and lowering interest rates? History and logic provide a clear but stark answer.

Seeing the Fed's aggressive money pumping, many people think that the "excess money" will soon spill over into commodity inflation. That's wrong. What isn't realized is that the money that has flooded into the financial bubble is effectively locked in.

We have shifted our view and are beginning to think the unthinkable. Having kept a critical eye on the actions of governments, central banks and markets, we see the possibility for depression in some countries.

The U.S. financial bubble frightens us most. Apparently, very few people are aware of the ominous parallels between today's Wall Street bubble and the bubbles of 1927-29 and more recently in Japan. We elaborate.

For the third time in as many years, the dollar has made an impressive recovery against the D-mark even though the underlying bull story has failed to hold.

We warn again that the French franc will be devalued. It is a great mistake to believe that an economy must be strong because it has low inflation rates. It's even possible that the entire EMS will unravel.

Long-term capital conservation and liquidity continue to be the top priorities. We continue to recommend safe harbour in the short-term money securities and bonds of the strong-policy currency countries — Germany, the Netherlands, Switzerland as well as Austria and Belgium.

THE U.S. BUBBLE ECONOMY

In view of the prodigious financial and economic excesses that built up in most countries during the 1980s, we have always held the opinion that the world economy would go through a sustained period of stagnation, or at best, very anaemic growth. Compared to the complacent consensus viewpoint, which incessantly hailed a coming recovery just around the corner, our perspective appeared very pessimistic.

Ever since 1990, though, there has been nothing but disappointment over economic growth. True, the U.S. economy has recovered, but it has done so at an unprecedentedly anaemic pace despite the most expansive mix of monetary-fiscal stimulus on record. As a result, forecasters, although still complacent and generally optimistic, have gradually down-sized their expectations in the direction of our view.

But new information and developments cause us to continuously reassess our economic and financial viewpoints. Unfortunately, having kept a critical eye on governments, central banks and market trends, we are beginning to think the unthinkable — that there's potential for depression in some major countries. This shift of view is due to three main reasons: first, thorough historical and theoretical research has provided us with new insights; second, the more we learn, the more we are convinced of the utter incompetence of our present world political leaders and policymakers; and lastly, structural budget deficits, dangerously swollen by the effects of recession, are slipping out of control everywhere.

PERCEPTIONS VERSUS REALITY

International apprehension has fixated on one main development — the German economy's slide into recession and the Bundesbank's hesitancy in lowering interest rates. Pronouncements by politicians and many economic reports give the impression that this is the world economy's main depressive influence. Force the Bundesbank to capitulate, they postulate, and the world economy would soon recover.

This misplaced focus and the widespread bias to blame Europe's recession on Germany, and the Bundesbank in particular, typifies the general ignorance that presently rules policies and the world's financial markets. What is conveniently overlooked is the fact that the current recession started outside of Europe. It was led by other countries, who, despite trying to forestall an economic downturn with drastic monetary easings, couldn't do so.

Policymakers and economists have yet to awaken to the realization that the present world economic downturn is something utterly at variance with any other period in the postwar era. Past recessions during this time were all dominated by inventory liquidations and typically played out within a year. The present global economic tribulations and policy paralysis, by contrast, find their cause in unprecedentedly high debt levels associated with heavy "maladjustments" in the aggregate capital and output structures of the economies. Without a doubt, all of these imbalances will require more than just a few years to correct.

FROM ONE BUBBLE TO ANOTHER

There is a complacent view that problems are receding . . . that the world is safely again navigating to solid ground. This is particularly believed to be so in the cases of Japan and the United States. We disagree. The liquidation of Japan's enormous debt and asset bubble and its associated huge malinvestments in real estate and industrial capacity, both domestic and international, has barely just begun. And in the case of the United States, few realize that the Fed has forestalled its current problems only by sowing the seeds of an even bigger liquidity crisis later by firing up a massive speculative frenzy on Wall Street in the stock and bond markets.

What's wrong with an asset bubble that has the wonderful effects of raising asset valuations and lowering interest rates? The hard reality of any major asset bubble is that it inevitably must end in a disastrous bust. Historically, inflationary bubbles were usually experienced in the commodities and real estate markets. Big stock and bond market bubbles, by contrast, have been relatively rare. However, they had the most pernicious after-effects, one important reason probably being that financial speculation involves wide public participation. The examples of the U.S. asset bubble of 1927-29 and the Japanese asset bubble of 1987-89 are well known.

Interestingly, Governor Mieno of the Bank of Japan is the first central banker in history who expressly identified and attacked "asset price inflation". When he first took office at the end of 1989, he began to raise interest rates even though consumer-price inflation was virtually zero. He was alert to the dangers of runaway asset speculation in Japan's real estate and equity markets and therefore tightened the monetary screws. His express aim was to prick the bubble preemptively before it would burst on its own accord from an even more extreme level of overvaluation causing even greater damage later on.

Mr. Mieno sent staff to study London's secondary banking crisis of 1974 and America's more recent savings and loan disaster. We wonder whether he also studied the U.S. asset price bubble of 1927-29.

THE SEEDS AND PARALLELS OF FINANCIAL BUBBLES

What's urgently needed, it seems, is a study that explores the theory and history of asset price bubbles and answers three key questions: How do asset bubbles come about; how do they essentially end; and when they do, how are the asset markets and the real economy impacted? For us, the historical record leaves little doubt as to what will happen with the present bubble: In the end, asset markets will crash all around the world and trigger prolonged depressions. Apparently, very few people are aware of the dark parallels between today's Wall Street bubble and the ones of 1927-29 in the U.S. and recently in Japan.

The mix of conditions that regularly leads to the rise of a bubble economy invariably includes protracted economic sluggishness and subdued inflation. It's a mix of conditions that deludes policymakers and economists into the erroneous conclusion that an uninhibited monetary easing is permissible and harmless. In fact, it's thought that if asset prices rise, so much the better. To most people, buoyant financial markets are a sign of health, not the warning signal of monetary inflation.

In its July issue, The Bank Credit Analyst writes: "*Structural deflation has brought virtual price stability (as measured by the Producer Price Index) for the first time since the early 1960s. This has allowed the Federal Reserve to drive short-term interest rates below the rate of inflation, causing negative real rates, and to pump massive amounts of liquidity into the economy. The result has been to inflate stock and bond prices . . . Global deflation has allowed the Fed to ease with little fear of a resurgence of price inflation.*"

THE STOCK MARKET PARALLEL

The above quote captures the current situation very well. But the key question is whether or not economic sluggishness permits protracted, unrestrained monetary easing. It brings us to the many parallels between the present Wall Street bubble and that of 1927-29. The first parallel, and undoubtedly the most disputed one, is the stock market. Ever since the 1930s, economic historians have argued over the links between the boom and bust of the U.S. stock market of the late 1920s and the following deflationary depression.

There exist two diametrically opposing explanations. One camp asserts that the depression of the 1930s owed little or nothing to the Wall Street crash. In this view, there were two other main culprits that caused the downturn: a banking crisis and the drastic monetary contraction that took place after 1930 which allegedly was to have been caused by an overly tight monetary policy following the crash. The attractive aspect of this theory is that it implies that the savage deflation and depression of the 1930s was merely the cause of a policy mistake. All that would have been required to correct it, therefore, would have been a determined policy of monetary ease on the Fed's part.

This view, which is more or less today's accepted explanation, was first articulated by Professor Milton Friedman in his book, Monetary History of the United States, published in 1963. Referring to an average rate of decline in wholesale prices of 1% per year between 1923 to 1929, he discarded the opinion that the 1920s were a period of inflation. The thought that an inflationary stock market bubble might cause deflation and depression once it burst was completely alien to him.

Mr. Friedman's assessment of the cause of the Great Depression soon displaced the previous theory that had wide acceptance. This theory instead held that the Wall Street crash and the following crisis was really the unavoidable sequel to the monetary and speculative excesses that had preceded it. In other words, the damaging monetary mischief had taken place earlier in 1927-29, and not later in the early 1930s. The crash and deflationary depression that followed were the predictable and inescapable consequence of the earlier excesses.

We have always sided with the latter, more orthodox view. During the depression years, this was the majority if not the consensus view in any case. Today, very few people are aware of the stock market connection. Everyone believes that it was the tight monetary policies of the Fed that triggered the crash and the following depression. Professor Irving Fisher, most famous for his glorification of the stock market boom as a harbinger of a "New Era" of price stability and low interest rates retreated to the orthodox view after the crash. He consented that "stock price inflation" was the main cause of trouble and conceded in hindsight, "*perhaps a once-for-all sharp increase in the rediscount rate two years ago might have prevented the market crash later.*"

What really did happen in 1927-29 that led to Fisher's reborn conclusion?

THE SAGA OF 1927-29

It all began in the autumn of 1927. Confronted with a sharply weakening U.S. economy and pressures from the British to support the pound, the Fed cut its interest rates and flooded the banks with reserves. The aim of these actions was to stimulate a credit expansion. But, as business credit demand failed to materialize, the banks instead used the new reserves to add to their bond holdings and security loans. By doing so, they not only created new deposits but also forced up bond prices and thereby lowered long-term interest rates. In the end, the chief effect of the Fed easing was an inflation of stock and bond prices.

To quote a League of Nations report of 1931: "*The credit expansion which took place during this period went largely into the financing of speculation.*" What we see is that financial speculation was overstimulated at the expense of economic activity. Sounds familiar, doesn't it?

What had happened in the real economy was that fixed investment slackened, particularly in building and construction, while consumer spending took off, most probably fuelled by the ephemeral profits of the

stock market boom. Yet, industrial production peaked in May-June of 1929 and was already declining well before the stock market crash of that Fall. Nonetheless, it was a very moderate downturn. Only after the stock market had crashed did the economy begin its plunge in earnest.

For economists of the Austrian school, the stock market bubble — from its creation to its final bursting — was the key development that definitively and dramatically framed and started the following catastrophic depression. Not to be forgotten were the evil side-effects that resulted from the financial bubble: overconsumption, overvaluation of assets, huge malinvestments, overindebtedness, and illiquidity. When the stock market finally collapsed, everything else collapsed, too.

Austrian theory (Mises, Hayek, etc.) tends to stress wasteful malinvestments and structural maladjustments in the real economy as the main causes of a following crisis. Large malinvestments in real estate play a regular role. Other sectors can be involved as well. In the case of Japan, recently, the bubble also fostered an enormous spending binge on industrial investment. By contrast, both U.S. bubbles — 1927-29 and today — spurred spending binges particularly in consumption.

FLEETING LIQUIDITY

Structural maladjustments are a very important factor in the demise of a bubble. Even more dangerous are the liquidity effects of a financial inflation. As long as the bubble inflates, it essentially creates a mirage of rising consumer wealth and abounding liquidity. In the 1920s, a new liquidity theory arose asserting that easily "shiftable" assets, like bonds or shares, represented real liquidity. It found many willing believers. Today, even Fed publications insinuate that bond and equity mutual funds are "*liquid enough to substitute for M2.*"

Before the 1929 crash, the markets were seen as being awash in liquidity. But all this wonderful liquidity instantly disappeared when stock prices tumbled. Between 1929 and 1933, the total value of all outstanding shares declined an estimated $85 billion or 90% of their value, an amount nearly corresponding to the total of aggregate U.S. Gross Domestic Product (GDP). A similar crash today would involve a collapse in stock values of more than $5 trillion. A wealth destruction of such magnitude is bound to unleash enormous deflationary dynamics.

In his book, The Great Crash 1929, J.K. Galbraith wrote that a good knowledge of what happened in 1929 remains our best safeguard against the recurrence of the unhappy events of those days. Obviously nothing has been learnt.

The one way to avoid a crash is to prevent a major asset boom to begin with. During the 1920s, many people — some also in the Fed — greatly worried about the stock market boom. They saw it as a symptom of an inflation that eventually would be vulnerable to a terrible bust. By contrast, today's Fed hails the booming markets and the sharp fall in long-term interest rates as a great testament to its excellent anti-inflationary policies.

In reality, the Fed's monetary easing over the last two to three years has been the loosest on record. It's certainly much more lax than it was in the 1920s. The money flooding into the stock and bond markets seems to be gushing out of a bottomless spring. But just as it did in the 1920s, the monetary largesse only hyper-stimulates the financial markets while the real economy responds only sluggishly. Most obviously, the river of speculative money doesn't spring from a savings boom. It finds its origin in three sources,

all precipitated by the Fed: first, through its unlimited supply of bank reserves; second, a very low Fed funds rate of 3% forcing paltry returns on certificates of deposits; and third, a yield curve of unprecedented steepness.

Combined, these three conditions powerfully propel money into U.S. stocks and bonds, and in the process, inflate their market values. It's the classic pattern of an "asset price bubble." Without a doubt, it's nothing other than the Fed's money pump that's behind the inflation of paper wealth.

Just as the Fed's easing is the most aggressive on record, the inflation in the stock market far exceeds that of 1927-29, too. The price-earnings-ratio (PER) for industrial stocks in early 1929 hit a high of 16.2. Just before the crash the PER was only 13.5. Presently, the average PER ratio for the Dow Jones Industrial stocks is at a lofty 32. The S&P 500 multiple is currently much higher than in 1929, too, at a ratio of 22.5. To make things worse, not only are valuations less attractive today, so are fundamentals. In the 1920s, the United States had much higher savings and the Federal budget was in surplus. Today, stocks are soaring on the back of an abysmal savings ratio and a record-high budget deficit.

THE LEVERS BEHIND THE BUBBLE

How has the present U.S. financial bubble been engineered? The two charts on the opposite page give a clear answer. They exhibit the three main ingredients: soaring bank reserves, leading to soaring bank purchases of bonds, in turn leading to soaring bond and stock prices.

Chronologically and causally, the financial inflation works like this: first, heavy bond purchases by the Fed persistently keep bank reserves in excess of banks' reserve requirements; second, the banks put these excess reserves to profitable use through massive bond purchases, leveraging up the Fed's initial reserves injections by a large multiple; and third, the bank purchases create an equal amount of bank deposits (money supply) and tend to lower long-term interest rates. As long as the Fed complies and keeps adding reserves, it becomes a self reinforcing daisy chain.

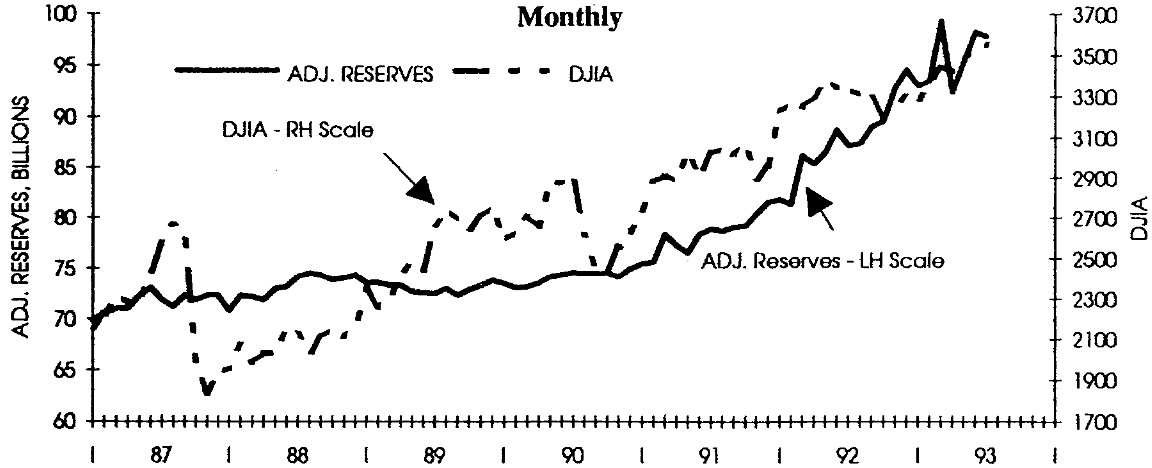
The data shows that this is exactly what happened. To begin with, in 1991-92, the Fed bought government bonds amounting to $59 billion. Bank purchases of government or government agency bonds in turn amounted to $213.5 billion, or almost four times the Fed's purchases. Brokers bought an additional $69 billion. Altogether, these three financial intermediaries gobbled up $341 billion worth of government bonds representing 59% of total net issues during these two years. Foreigners took a further $114 billion out of the government bond market during this period.

These figures leave little doubt as to what's behind the sharp decline in U.S. long-term interest rates. It's not personal and institutional savings; it's the Fed, banks, brokers and non-residents. Additionally, the above figures make a mockery of the notion that the sharp rise in U.S. bond prices reflects declining inflationary expectations on the part of the public. During 1991-92, the public's (individuals and non-bank institutions) share of treasury and agency bond purchases was barely 20% of the total.

Recent statistics show a continuation of the same dynamics. During the first quarter of 1993, the U.S. government absorbed fully 83% of total credit growth. Moreover, 58% of the government's credit requirement was financed by the Fed, banks, brokers and foreigners.

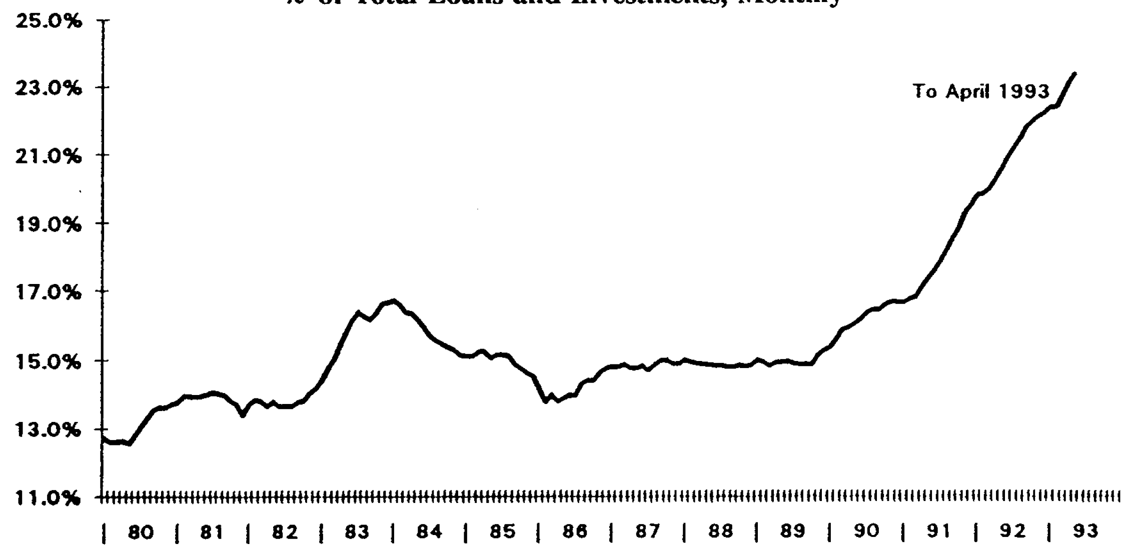
What's good for the bond market has been good for the stock market as well. Lower long-term interest

U.S. ADJUSTED RESERVES VERSUS THE DOW JONES INDUSTRIAL AVERAGE
Monthly



Sources: U.S. Federal Reserve Bank of St. Louis Format: CCM

U.S. BANKS: GOVERNMENT INVESTMENTS
% of Total Loans and Investments, Monthly



Source: Federal Reserve Format: CCM

rates have driven up stock valuations. But the biggest propellant for the stock market has been the rate shock of extremely low short-term interest rates. Legions of investors have fled low-yielding bank deposits and bought equity mutual funds, believing Wall Street propaganda that share prices can only rise.

Clearly, what we see is a notorious "bubble" fuelled by the most aggressive monetary ease on record. What's obvious, too, is this: If the Fed ever dares to moderate its monetary ease, the bubble would surely burst. As banks and brokers begin to dump their bonds, long-term interest rates would shoot up, bursting the stock market boom and aborting the economic recovery.

WILL FINANCIAL INFLATION SPREAD?

Given the rampant inflation in the financial markets, what are the implications for the markets and the economy over the longer run? What will be the object of the next great speculation? Is the U.S. economy on the verge of an inflationary spiral or a deflation? The common answer we hear and read more and more of lately, is to expect an impending commodity inflation.

The reasoning seems plausible. Bank reserves, the monetary base, and M1, are all soaring at double-digit rates and, as such, are telltale signs of rampant inflation. While the main object of the underlying inflation are financial markets for the time being, the thinking goes that the excess money will sooner or later switch its attentions from overvalued financial assets to cheap commodities. When that happens, commodity prices are expected to boom. Therefore, the great recommendation is to buy commodities before the stampede begins.

Delusions create illusions. The great delusion in this case is the premise that all the money that has been inflating the financial bubble will be available to inflate commodity prices tomorrow. That's wrong. Such a big switch is simply not feasible. What isn't realized is that all the money that went into the bubble is now locked in. In order to exit, the owners of the inflated assets will have to find others who are ready and able to buy them at the given prices. Who is going to be left to buy when the bulls want to sell? To bail out the bulls would require an even more massive monetization by the banks, which is unlikely since they are already overloaded with bonds.

Given the buoyant markets presently, stocks and bonds are highly liquid assets for their owners. But whenever the inflated transaction levels cease, the markets are bound to weaken. The worst thing that could happen is a massive exodus attempt. Any heavy selling would instantly trigger a price collapse. That is what precisely happened in 1929-33. Any inflationary bubble, whatever the asset — real estate, commodities, gold, stocks, or bonds — essentially ends in a crash.

The present U.S. financial bubble is already far too big to be reined in without a crash. Unfortunately, a large-scale destruction of personal wealth and liquidity at some point is virtually inescapable. The outcome would be very different than the one commodity bulls presently foresee. Far from leading to rising commodity prices, any flight from the overvalued financial assets would have just the opposite effect: devastation of private wealth and liquidity would spread deflation far and wide.

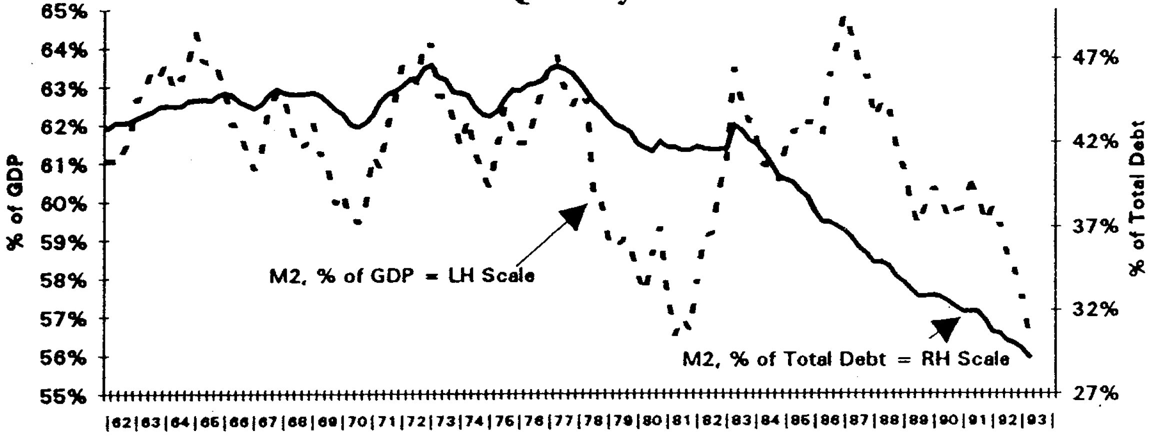
ILLUSIONS OF LIQUIDITY

While Wall Street still sees an economy and a financial system awash in liquidity driving up stock and bond prices, we see an economy and financial system that is becoming increasingly illiquid. It's plain to see. Broad money (M2) is falling dramatically short of current growth in debt, GDP and the market capitalization of stocks and bonds.

The following graphs show this progressive shortfall of M2 relative to overall debt and the decline of liquidity relative to the capitalization of U.S. financial markets. Inflation doesn't start this way, deflations and depressions do.

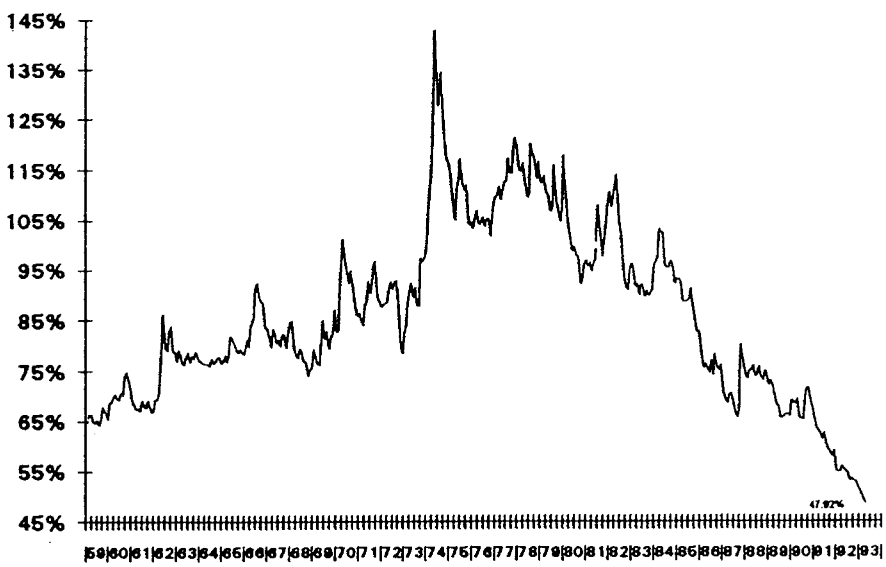
To us, the evidence we've shown seems conclusive. The present financial boom is a bubble that will burst one day with great depressive effects on the economy. But just as in 1927-29, as long as the euphoria

U.S. LIQUIDITY TRENDS
M2 AS A % OF TOTAL DEBT AND GDP
Quarterly



Source: Federal Reserve Format: CCM

CASH TO EQUITY AND FIXED-INCOME MARKET CAPITALIZATION



This ratio is the total of time deposits (CDs), savings deposits, money market funds to total capitalization of the equity (NYSE, AMEX, NASDAQ) and fixed-income market (Lehman Aggregate).

Source: Arbor Trading Group Inc., Lehman Brothers, Ibbotson Associates, Federal Reserve of St. Louis

on Wall Street lasts, it fuels optimism on the real economy. That brings us to the important question of the currency markets.

WEAK UNDERPINNINGS TO THE DOLLAR EUPHORIA

Dollar bullishness hasn't been so strong since the fall of 1989. The consensus sees the U.S. dollar soaring to DM 1.80-2.00 by year-end, driven up by a strong U.S. economic recovery. The reasoning is that an associated rise in inflation would inevitably cause the Fed to shift to a monetary tightening. At the same

time, Germany's slide into recession is expected to force the Bundesbank to slash its interest rates. This combination of events is envisioned to send the dollar off on a skyward trajectory.

Well, for the third time in as many years, the dollar has made an impressive recovery against the D-mark even though the underlying bull story has failed to hold. Instead of forging ahead, the U.S. economy's recovery is so anaemic that any rise in U.S. interest rates, no matter how modest, is virtually unthinkable. Conversely, the Bundesbank has not been flustered. It is biding its time in lowering rates.

Determined dollar bulls, it seems, never allow inconvenient facts to disturb them. Far from deploring U.S. economic sluggishness, it is hailed as the best of all worlds, assuring monetary ease and bullish financial markets forever. By contrast, the Bundesbank's cautious policy is presented from the distressing perspective that the longer it drags its feet, the worse the economic shambles and the sharper the interest rate cuts will have to be later.

AN ASSESSMENT OF GERMANY

Temporarily, the German economy appeared to be in a free fall compared to the U.S. economy's moderate downturn. With its large industrial sector and its high investment ratio, though, the German economy is naturally far more exposed to cyclical fluctuation than the U.S. economy. Additionally, German unification, with its attendant spending surge, exaggerated and prolonged the prior boom.

Essentially, the German economy's rate of decline has slowed and is presently flattening out. Yet, this says nothing about any impending recovery and its likely steepness. There is an unrealistic expectation in Germany and Europe, as reflected in buoyant share markets, that U.S. growth will lead a world recovery. We are not so optimistic. We see a general disappointment over economic growth taking place as an interdependent world pays for its past excesses. Still, it's important for the investor to assess which economies are relatively weaker or stronger.

For a long time now, markets have been spewing doom and gloom over Germany, which, indeed, suffered a sharp downturn. But this is a horror story which is starting to get rather stale as far as the foreign exchange markets are concerned. Neither the fantasies about the demise of the German economy and its currency nor the optimism on the U.S. economy are based on reality.

It is true that the Kohl government has financially mishandled unification and has turned it into a extremely large burden for West Germany. However, German financial and economic fundamentals are much stronger than most people seem to realize. Importantly, it is the one major country that steered clear of the financial excesses that ravaged most other economies in the 1980s.

It is not an exaggeration to say that Germany was an anomaly in the 1980s. While the Anglo-Saxon countries experienced consumer-led and debt-financed growth, German expansion was investment- and export-led. In Germany's case, capital formation soared at the expense of consumer and government spending. Companies and banks saw rising profits. No consumer borrowing binge and corporate leveraging boom occurred as in the Anglo-Saxon countries. Households maintained a high savings ratio and still do. In fact, credit during this period expanded at its slowest pace of the postwar period.

Still, two things went to inflationary excess in the late 1980s: exports and the related industrial investments. The inflation that fuelled the overexpansion of these two, though, occurred outside of

Germany, mainly in Britain, Italy, Spain . . . etc. Soaring, inflated demand in these countries spilled over into Germany, especially as Europe's currency system became rigid after 1987. This created a second problem for Germany besides the demands of unification. It now has to digest these related maladjustments in industrial investment.

Considering the immensity of the fiscal burden of unification, running at about 6% of GDP, it is surely most remarkable that Germany still has a considerable surplus in merchandise trade. Compare this with the fact that the U.S. trade deficit has deteriorated sharply despite a very sub-par recovery. Looking forward, in coming months markets should awaken to the fundamental weakness on the U.S. dollar side of the currency axis. The doom and gloom on Germany is not likely to get any worse. To repeat, we see huge risks in the U.S. financial bubble. Literally, U.S. markets are living on borrowed time.

THE RISE AND FALL OF THE FRENCH FRANC

The speculative pirates roving the international currency markets are looking for new victims from which to extort easy and big plunder. This time the Danish krone and the French franc are on the firing line. Considering the recent hubris about the franc replacing the D-mark as Europe's anchor currency, its new fall from grace has an air of humiliation.

We have been warning that the French franc will be devalued. The basic reason for this view is our conviction that the world economy will be weaker than generally expected and that the French economy is much too vulnerable to endure extremely high real interest rates much longer. It is a great mistake to believe that an economy must be strong because it has low inflation rates.

With an unemployment rate of 11.5% already near the start of a recession, there is something obviously wrong with the French economy. Following a credit boom in the 1980s which financed heavy corporate leveraging and over-investment in commercial real estate, the French today are experiencing a liquidity crunch. Therefore, both the economy and its financial system urgently need sharply lower interest rates. While the Bundesbank may assist the French to a point, it should be apparent that it cannot deliver the low interest rates that France so desperately needs. French politicians should have known this long ago.

The French argument that Maastricht (the European agenda for monetary unification) and a fixed rate against the D-mark have absolute priority in their policy is absurd. This decision has nothing to do with economics but everything with the aspirations and obsessions of the French politicians. A devaluation of the French franc, they fear, would definitely jeopardize the common European currency plan, which from the French politicos point of view, would have been the happy end of the D-mark's anchor role in Europe.

CONCLUSIONS

The world economy is mired with countries that are either experiencing outright recession or shaky, unsustainable recoveries. For the time being, financial markets revel in this scenario presuming that it means easy money and financial nirvana "as far as the eye can see."

Very few are able to see the ominous underpinning to the buoyant financial markets and the economic optimism. As we have tried to show, the excesses of the 1980s still hold their legacy. Don't be fooled. These past excesses have just been papered over and transformed into the guise of prosperous, appreciating financial markets — a huge and dangerous "financial bubble."

Based on our theoretical and historical knowledge of "financial bubbles" we can say this: They are usually the last, most precarious, and violent chapter of maladjusted and sick economies. It is a great mistake to conclude that the buoyant financial markets reflect abounding liquidity. Instead, we think they will prove to be a giant liquidity trap. True liquidity as measured by broad money, remains at record lows.

A massive destruction of wealth is inevitable at some point. It will have huge deflationary implications for the overinflated economies particularly, and the world economy in general. Only the timing is unclear.

Already, there is sharply increased volatility and rotation in the markets reflecting growing confusion, uncertainty and short-term speculation among investors. That's a warning signal.

Europe will remain mired in recession and currency turmoils as long as the EMS persists. What may be required is a general floating just to take the speculative heat out of the markets. The fact remains that the Bundesbank's leeway to lower rates is too limited relative to the urgent needs of France and Denmark.

We fear continued disappointments on world economic growth. In fact, once the financial bubble in the U.S. bursts, impacting world markets, we expect to see economic depressions take hold in some countries.

Over the short-term, anything is possible. There are many trouble spots in the world making it virtually impossible to predict which one will erupt first. If the French franc devalues soon, the European Monetary System (EMS) will have effectively unravelled, potentially buoying the U.S. dollar for a time. But the reality in the end is this: a bust of the "financial bubble" in the U.S. and the recognition of a renewed economic downturn will be hugely negative for the dollar.

What should conservative investors do to preserve their wealth during these volatile times? As we have often stated, short-term timing is a mugs game. It is better to invest along more certain long-term trends. To that end, countries with the least excesses and the best balanced economies are the safest harbours.

We stand by our long-running recommendations: For American investors, there is little else to do other than to continue seeking safe harbour in riskless short-term money and to diversify into hard currencies. Investors outside of North America should stick with bonds in the strong-currency countries, namely Germany, the Netherlands, Switzerland, Austria and Belgium.

Next Mailing: September 1, 1993

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